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In the Supreme Court of the United States

OCTOBER TERM, 1972

No. 71-1022

UNITED STATES OF AMERICA, PETITIONER

v.

JAMES A. BASYE and EVELYN E. BASYE, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the district court (Pet. 15-29)[1] is reported at 295 F. Supp. 1289. The opinion of the court of appeals (Pet. 31-42) is reported at 450 F. 2d 109.

JURISDICTION

The judgments of the court of appeals (Pet. 43-48) were entered on September 16, 1971. By order

[1] "Pet." references are to the petition for certiorari.

dated December 10, 1971, Mr. Justice Douglas extended the time for filing a petition for a writ of certiorari to and including February 12, 1972. The petition was filed on February 9, 1972, and certiorari was granted on April 3, 1972 (R. 220).[2] The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether compensation for services rendered by a medical partnership, made payable by contract, and paid, to a trust, is income of the partnership, and therefore taxable to the partners, as the United States contends, or whether, as the courts below held, such compensation is not partnership income and will constitute income to the beneficiaries of the trust only when distributed to them.

STATUTES INVOLVED

The pertinent provisions of Sections 61, 401, 404, 701, 702, 703 and 704 of the Internal Revenue Code of 1954 are set forth in the Appendix, *infra*, pp. 26-29.

STATEMENT

Respondents are physicians and partners[3] in a medical partnership, Permanente Medical Group

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[2] "R." references are to the separately bound record appendix.

[3] "Respondents" refers collectively to James A. Basye, Carol L. Cook, Maurice C. Fishler, Henry Donald Grant, William S. Hunter, Jessamine S. Hunter, and Nadia Sorokowski,

("Medical Group"), which was organized in 1949 for the practice of medicine in California. In 1960 the partnership had over 200 physician-partners, 41 physician-employees, and an unstated number of other employees (R. 82-83). Under the partnership agreement (R. 101-113), the partners had drawing accounts varying with responsibility and seniority, but were to share equally in net earnings in excess of drawing accounts (R. 105-106). The partnership reported its income on the accrual basis, and for a fiscal year ending June 30th (R. 80-81, 82, 83, 105-106).

In 1959, Medical Group entered into a detailed written agreement (R. 114-154) with Kaiser Foundation Health Plan, Inc. ("Health Plan"), an organization supplying prepaid medical care and hospital service to its members, of whom there were approximately 359,000 in its Northern California Region. This agreement, which succeeded earlier agreements between the two organizations, was for a period of two years from July 1, 1959, through June 30, 1961, and from year to year thereafter, subject to termination or renegotiation upon written notice given by either party ninety days prior to the end of

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each of whom was a physician and partner during the years involved. Evelyn E. Basye, Jack J. Cook, Phyllis H. Fishler, Jean M. Grant, and George W. Sorokowski are parties to these actions only because they filed joint income tax returns with their respective spouses, and, in the case of Jean M. Grant for the year 1960, because she reported one-half of the community income in a separate return.

any year. Under its terms, Medical Group agreed to provide to all members of Health Plan within its Northern California Region all medical services required by or incident to membership contracts. (R. 82-88, 121-122, 123, 124-125, 133.)

With respect to compensation, the agreement provided (R. 137): "As base compensation to Medical Group for Medical Services to be provided by Medical Group hereunder, Health Plan shall pay to Medical Group the amounts specified in this Article H." Article H (R. 137-139) then set forth the two items constituting base compensation. The first, payable directly to Medical Group, was a stated amount (originally $2.61329) per member per month, subject to adjustments as provided in Sections H-2 and H-3. The second item of base compensation called for the payments that have given rise to this litigation. It was to be made up of payments required (R. 139) "In the event that Medical Group establishes a savings and retirement plan or other deferred compensation plan approved by Health Plan * * *." Though establishment of this plan was thus stated to be contingent, and was deferred for several months, it was agreed that Health Plan's contributions thereunder (later agreed to be 12 cents per member per month) should commence as of July 1, 1959 (the effective date of the agreement), and that Health Plan's obligation to make such contributions should continue only so long as the agreement or any continuation or extension generally similar to the agree-

ment should remain in effect.* (R. 83, 137-139, 162.)

The plan contemplated by the agreement was established later in 1959 by a trust agreement executed by Medical Group, Health Plan, and a bank serving as trustee (R. 158-199). Under it, Health Plan made a payment of $200,000 to the trust at the outset, and agreed to make further payments on a per-member, per-month basis during the period in which the agreement between Medical Group and Health Plan remained in effect. The funds paid to the trust, less fees and expenses, were to be paid over to an insurance company in order to pay retirement benefits to partners and physician-employees of Medical Group, computed on a complex of factors such as age, years of service, and compensation level. Tentative allocations to potential beneficiaries were made when funds were received, but no interest vested prior to retirement, and potential benefits might be lost prior to, or after, retirement by withdrawal from Medical Group for practice other than with another group serving Health Plan's members. In that event, amounts allocated to a participant's tentative account were re-allocated to the tentative accounts of other participants. Upon retirement of a partner or a physician-employee qualified by age and years of service, the amounts credited to his tentative account were to be applied to purchase a retirement income

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*In addition to the items of base compensation, it was agreed that Health Plan should also pay to Medical Group fifty percent of Net Health Plan Revenue (as therein defined), if any. (R. 139-141.)

contract. The trust was subject to amendment at any time by Health Plan and Medical Group. (R. 83, 92-97, 162-163, 164-170, 182.)

The primary purpose of this feature of the agreement was to create an incentive for physicians to remain with Medical Group, and thus to insure Health Plan that it would have a stable and reliable group of physicians providing services to its members with a minimum of turnover. However, as the respondents asserted in their claims for refund, it served also the independent, and in some respects conflicting, interests of Medical Group and the participating physicians. (R. 11, 22, 47, 51, 55, 59, 83-84.)

The agreement between Medical Group and Health Plan contemplated that membership in the partnership would change from time to time, and provided that the agreement should continue in effect regardless of the withdrawal from Medical Group of individual partners or the addition of new partners as long as most physicians than partners continued their association as then organized or as reorganized through voluntary action. The partnership agreement constituting Medical Group provided that the partnership should continue despite the death, retirement, or withdrawal of partners; it provided also for the addition of new partners, and for the method of termination of the partnership. The trust agreement also provided for its continuation as long as fifty percent of the participants continued in association or in reorganized form. In case of dissolution of the partnership or a reorganization not qualifying within the provisions for continuity, then the assets

held under the trust agreement were to be promptly liquidated, and the net proceeds distributed by lump-sum payments to the participants then entitled thereto. (R. 97, 110, 113, 135, 174, 175.)

Health Plan paid to the trust, on a monthly basis, an aggregate of more than $2,000,000 during the period from its first payment in Medical Group's fiscal year ending June 30, 1960, until it discontinued payments at a point in Medical Group's fiscal year ending June 30, 1963. Medical Group did not include these payments in its returns of taxable income, and they were not included in the partners' distributive shares of gross or taxable income. The Commissioner of Internal Revenue assessed deficiencies against the respondent partners for 1960 and 1961 on the ground that the compensation for services of the partnership constituted gross income of the partnership, deflected to the trust through contractual arrangement with Health Plan; and, therefore, that the partners were taxable on their distributive shares of such income. Respondents paid the taxes in dispute and, after their claims for refund were denied, brought these actions for refund.* (R.

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* In the case of the respondents George W. Sorokowski and Nadia Sorokowski, the assessments, claims for refund, and suit for refund included the years 1962 and 1963, in addition to 1960 and 1961. Dr. Sorokowski withdrew from Medical Group in September, 1963, and thereby forfeited rights to receive payments from the trust. In 1966, the District Director of Internal Revenue on his own initiative made an administrative determination that Dr. Sorokowski was entitled to a deduction for 1963 equal to the sum of the amounts that had been the basis for deficiency assessments made against her

81, 84-86.)

The cases were consolidated in the district court and were heard upon an agreed statement of facts (R. 80-88), accompanied by an Appendix (R. 89-100), and documentary Exhibits A through F (R. 101-204).

Both courts below held that the partnership realized no gross income from the payments made by Health Plan to the trust because the partnership never had the right to receive them. They further held that the partnership should be considered merely the agent of the partners, and should otherwise be disregarded in determining their tax liabilities. Treating the partners merely as contingent trust beneficiaries, the lower courts concluded that they would be taxable on payments to the trust only at such times as distributions were made by the trust. (Pet. 15-29, 31-42.)

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for 1960, 1961, 1962, and 1963, and computed an overpayment of the Sorokowskis' income taxes for 1963 in the amount of $3,298.58. In March, 1967, the Internal Revenue Service mailed to the respondents Sorokowski a check in the amount of $3,875.31, representing a refund of the over-assessment determined, plus interest thereon. (R. 86-87). To this, Dr. Sorokowski responded by letter from her counsel, Exhibit F (R. 204.) The United States in May, 1967, filed a protective counterclaim by way of set-off in the action by the respondents Sorokowski, setting forth the facts of this refund. The district court, in entering judgment for the respondents Sorokowski, allowed the counterclaim of the United States by way of set-off. (R. 69-71, 86-87, 210-211.)

SUMMARY OF ARGUMENT

The government's position in this case involves two steps, each grounded upon a fundamental income tax decision of this Court.

1. The first principle of income taxation was established by this Court's decision in *Lucas* v. *Earl*, 281 U.S. 111, that income must be taxed to him who earns it, and that anticipatory arrangements to deflect payment elsewhere will not serve to avoid responsibility for the tax on income from services. Accordingly, when Health Plan agreed to pay, and paid, compensation for medical services rendered by Medical Group to Health Plan's members, the entire amount of that compensation constituted partnership gross income to Medical Group, though part of it was paid, as agreed, to a trust rather than directly to Medical Group. The fact that the form of the payment served to advance the interests of Health Plan made it none the less income to Medical Group.

2. This Court held in *Heiner* v. *Mellon*, 304 U.S. 271, that each partner in a partnership must take into his current income his proportionate share of partnership income despite the fact that distribution was necessarily held in abeyance. Accordingly, the fact that part of Medical Group's partnership income was to be held in trust did not serve to avoid the partners' liability for taxation of their proportionate shares. The court below simply disregarded this fundamental aspect of the taxation of partnerships and partners, and viewed the case as involving taxa-

tion of contingent beneficiaries of a trust. But partners are liable to taxation upon their proportionate shares of partnership income without reference to whether they, or others, are beneficiaries of a trust created to receive and hold partnership income.

3. The effect of the decision below is to circumvent the limitations that Congress has imposed upon qualified pension trusts. Such trusts combine the tax benefits of current deductibility for employers with deferred taxation of employees. But their availability, both in the years here in question and subsequently, is restricted by a number of limitations, such as those against discrimination, that the trust in this case clearly does not meet. Nevertheless, the decision below affords to a clearly unqualified pension trust tax benefits that Congress has restricted to trusts meeting the rigorous standards established by the Internal Revenue Code. The effect is therefore to invite partnerships large and small, in any business or profession, to defer the taxation of as much partnership income as they may choose by the device of having such income paid directly to a trust that meets none of the requirements of qualified pension trusts.

ARGUMENT

I.

PAYMENTS MADE BY HEALTH PLAN PURSUANT TO ITS AGREEMENT WITH MEDICAL GROUP, INCLUDING BOTH PAYMENTS MADE DIRECTLY TO THE PARTNERSHIP AND THOSE MADE TO THE TRUST, CONSTITUTED PARTNERSHIP INCOME.

Section 61(a) of the Internal Revenue Code of 1954, Appendix, *infra*, defines gross income to include, among other items: "(1) Compensation for services, including fees, commissions, and similar items."

More than forty years ago, in a decision that has stood without question as one of the foundations upon which the structure of the graduated income tax has been built, this Court held in *Lucas* v. *Earl*, 281 U.S. 111, that a taxpayer who has earned compensation for services must include that compensation in his gross income even though, by effective assignment, payment has been deflected and channeled to another. The Court has subsequently described that decision as embodying "the first principle of income taxation: that income must be taxed to him who earns it." *Commissioner* v. *Culbertson*, 337 U.S. 733, 739-740. See also *Commissioner* v. *Sunnen*, 333 U.S. 591, 604.

The statements that the Court made in *Lucas* v. *Earl* set forth the basis of its decision with conciseness and clarity (281 U.S. at 114-115):

> There is no doubt that the statute could tax salaries to those who earned them and provide

> that the tax could not be escaped by anticipatory arrangements and contracts however skilfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.

Those statements of first principles bear upon this case with as much directness and force as they did upon *Lucas* v. *Earl*. Though "anticipatory arrangements and contracts" may have prevented Health Plan's payments to the trust "from vesting even for a second" in Medical Group, they can not serve to eliminate this element of the compensation for Medical Group's services from the partnership's taxable income.

There can hardly be room to question that Health Plan's payments to the trust, as well as its payments directly to the partnership, were, and were intended to be, compensation for the services rendered by the partnership under the Medical Service Agreement (Ex. B, R. 114-157). They surely were not gifts, and they were made as a direct part of the employment arrangement. The agreement called for medical services by the partnership, and explicitly included (R. 137) in "base compensation" therefor the payments to be made to the trust as well as those to be made directly to the partnership, all as detailed in Article H (R. 137-139) of the agreement. Additional

contingent compensation was provided for in Article I (R. 139-141). In Section C-3 (R. 126), in Article I (R. 139), and in Article J (R. 141), reference is made to the compensatory arrangements set forth in Article H. The trust agreement itself (Ex. C, R. 158-199) refers to Health Plan's obligation to contribute to the trust as being derived from the service agreement with the partnership, and indicates the compensatory nature of the payments by providing that they will be coterminous with the effectiveness of the agreement with the partnership (R. 162).

Despite the patent parallelism between this case and *Lucas* v. *Earl*, the court below thought that that decision was not controlling here because (Pet. 39) "a crucial element * * * is missing here. Permanente never had the right itself to receive the payments made into the trust as current income." But that was equally true in *Lucas* v. *Earl*, and the same court made much the same point when that case was before it. See *Earl* v. *Commissioner*, 30 F. 2d 898, 899 (C.A. 9). Mr. Earl made the effective assignment in 1901, and the income there in question consisted of fees and salary earned in 1920 and 1921, so that he, also, "never had the right * * * to receive the payments." It was because of that feature of the case that this Court pointed out that "the tax could not be escaped by anticipatory arrangements and contracts however skilfully devised to prevent the salary when paid from vesting even for a second in the man who earned it." It has been equally true in numerous cases following *Lucas* v. *Earl*, where de-

flecting arrangements were made prior to the rendition of services, that the taxpayer "never had the right itself to receive the payments."* And this Court's decision in *Helvering* v. *Eubank*, 311 U.S. 122, makes it clear that an attempted deflection of earned income is ineffective to avoid tax liability whether the deflecting arrangement is made before the income is earned, as in *Lucas* v. *Earl*, or after, as in *Helvering* v. *Eubank*.

The controlling fact here, as in *Lucas* v. *Earl*, is that the payments were made as compensation for personal services rendered, and those services were rendered, pursuant to the agreement, by the partners and employees of Permanente Medical Group. For more than 40 years, it has been established and accepted in our tax law that the result of these facts is that the income is taxable to the entity—individual or partnership—which rendered the services, regardless of any arrangement, anticipatory or otherwise, designed to deflect it elsewhere.

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* *Allen* v. *Commissioner*, 410 F. 2d 398 (C.A. 3), affirming *per curiam*, 50 T.C. 466; *Hicks* v. *United States*, 314 F. 2d 180 (C.A. 4); *Megibow* v. *Commissioner*, 218 F. 2d 687 (C.A. 3); *Mayes* v. *United States*, 207 F. 2d 326 (C.A. 10); *Miller* v. *Commissioner*, 144 F. 2d 287 (C.A. 4); *Villere* v. *Commissioner*, 138 F. 2d 905 (C.A. 5); *Hogle* v. *Commissioner*, 132 F. 2d 66 (C.A. 10); *Comer* v. *Davis*, 107 F. 2d 355 (C.A. 5); *Jones* v. *Page*, 102 F. 2d 144 (C.A. 5); *Commissioner* v. *Bonwit*, 87 F. 2d 764 (C.A. 2), certiorari denied, 302 U.S. 694; *Canaday* v. *Guitteau*, 86 F. 2d 308 (C.A. 6); *Saenger* v. *Commissioner*, 69 F. 2d 631 (C.A. 5). Compare the "technically elegant" arrangement held ineffective in *Griffiths* v. *Commissioner*, 308 U.S. 355, 357; *Commissioner* v. *Laughton*, 113 F. 2d 103 (C.A. 9).

As the phrasing of the Court's opinion in *Lucas* v. *Earl* anticipated, it is immaterial that, as here, the deflecting arrangement was made in the contract under which the income was to be earned, rather than by a separate instrument of assignment. *United States* v. *Joliet & Chicago R. Co.*, 315 U.S. 44; *Galt* v. *Commissioner*, 216 F. 2d 41 (C.A. 7), certiorari denied, 348 U.S. 951; *Allen* v. *Commissioner*, 50 T.C. 466, affirmed *per curiam*, 410 F. 2d 398 (C.A. 8). If a contractual arrangement to insulate a taxpayer from receipt of compensation he earned could immunize him from taxation, the force of *Lucas* v. *Earl* would be reduced to wavering admonition.[1]

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[1] This Court long ago differentiated between consensual or contractual arrangements for the deflection and division of income (*Commissioner* v. *Harmon*, 323 U.S. 44), and deflection or division imposed by law (*Poe* v. *Seaborn*, 282 U.S. 101). Cf. *Commissioner* v. *First Security Bank*, No. 70-305, decided March 21, 1972.

In *Teschner* v. *Commissioner*, 38 T.C. 1003, relied upon by both courts below, the majority stressed a factor not here present—the fact that the taxpayer had no part in negotiating or establishing the terms of the contest of which he was the winner. Otherwise, the majority in *Teschner* wrote of deflection of income, as did the court of appeals in this case, in terms of the discussion of control in *Helvering* v. *Horst*, 311 U.S. 112. While *Horst* is, of course, a leading decision on the deflection of income, it dealt with deflecting income from property where, as pointed out in *Commissioner* v. *Sunnen*, 333 U.S. 591, 603-610, ownership or control of the income-producing property, or control of the flow of income, are the appropriate determinants. But with regard to the deflection of compensation for services, the "first principle" is that "income must be taxed to him who earns it" (*Commissioner* v. *Culbertson*, *supra*, 337 U.S. at 739-740), so that "compensation for personal services * * * is an inherently non-assignable gross income item." Lyon and Eustice, *Assignment of Income*,

The fact that the formal arrangements made for payment to the trust of part of the partnership's compensation advanced the interests of Health Plan does not make the payments any the less compensation, or remove them from the broad sweep of the definition of gross income in Section 61(a). *Commissioner* v. *LoBue*, 351 U.S. 243. This Court has only recently held that increased compensation paid with a view to reducing turnover and increasing stability in employment is not for that reason any the less taxable income. *Bingler* v. *Johnson*, 394 U.S. 741. "[N]o distinction can be taken according to the motives leading to the arrangement * * *." *Lucas* v. *Earl*, 281 U.S. at 115. The view of the court of appeals (Pet. p. 40) that payments to the trust were not "compensation for immediately past medical services but as compensation for the continued, long-term services of individual physicians" is difficult to reconcile not only with the partnership obligation but also with the facts that payments varied from month to month with the number of Health Plan's members in the same fashion that direct payments to the partnership varied, that

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17 Tax L. Rev. 295, 388 (1962). See *Strauss* v. *Commissioner*, 168 F. 2d 441 (C.A. 2), certiorari denied, 335 U.S. 858, rehearing denied, 335 U.S. 888, where decision turned upon whether the deflected income was from property or from services. Even by the *Horst* standards of control applicable to income from property, there would be basis for attributing to the partnership the income paid to the trust. Medical Group, and Health Plan, acting together, had extensive powers in the administration of the trust. (R. 166-168, 170, 175, 176-178.) They had complete power to amend the trust. (R. 182.) Cf. Internal Revenue Code, Sec. 674-678. Health Plan, as a participant in these powers, was a non-adverse party within the statutory definition. Sec. 672(a) and (b).

they were to be made while, but only while, the medical service agreement with the partnership was in effect, and that membership in the partnership was subject to change (R. 108, 112, 113, 129-130, 135). But even if the court were correct in that view, the monthly payments, whether for current or for anticipated services, would be no less current income to the partnership. *Bingler* v. *Johnson*, 394 U.S. at 757; *Schlude* v. *Commissioner*, 372 U.S. 128.

If Health Plan's wish to create or encourage stability in the group of physicians who served it were the philosopher's stone that would convert payments concurrent with service into something other than gross income, we should undoubtedly find marked changes in employment patterns throughout the nation. Employers who professed to seek enhanced stability in employment would undoubtedly soon be making payments into such tax-insulated receptacles as, for example, educational trusts for the benefit of employees' children. Grateful employees would find satisfaction in the prospect of tax deferred (or possibly tax-free) dollars being devoted to their families' future welfare. Only the revenues would suffer.

In sum, if *Lucas* v. *Earl* is to retain the unquestioned authority that it has had for forty years, then all of Medical Group's "base compensation" for services, including that part paid to the trust as well as that part paid directly, must be included in partnership gross income.

II.

EACH PARTNER IN MEDICAL GROUP, INCLUDING THE PRESENT RESPONDENTS, SHOULD HAVE INCLUDED IN HIS GROSS INCOME FOR THE YEARS IN QUESTION HIS DISTRIBUTIVE SHARE OF PARTNERSHIP INCOME.

If, as we believe we have shown, the payments made by Health Plan to the trust as well as those made directly to the partnership were includable in partnership income, then each partner, including the present respondents, should have included in his gross income his proportionate share of the increased partnership income. Internal Revenue Code, Section 61 (a) (13).

Though Subchapter K of Chapter 1 of the Internal Revenue Code of 1954 greatly expanded the detail of the tax treatment of partnerships and partners,* the structural scheme now embodied in Sections 701 through 704, Appendix, *infra*, pp. 28-29, has remained unchanged since the enactment of Section II, D,* of

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*H. Rep. No. 1337, 83d Cong., 2d Sess., p. 65 (3 U.S.C. Cong. & Adm. News (1954) 4017, 4091); S. Rep. No. 1622, 83d Cong., 2d Sess., p. 89 (3 U.S.C. Cong. & Adm. News (1954) 4621, 4721, 4722).

" * * *Provided further*, That any persons carrying on business in partnership shall be liable for income tax only in their individual capacity, and the share of the profits of a partnership to which any taxable partner would be entitled if the same were divided, whether divided or otherwise, shall be returned for taxation and the tax paid, under the provisions of this section, and any such firm, when requested by the Commissioner of Internal Revenue, or any district collector, shall forward to him a correct statement of such profits and the names of the individuals who would be entitled to the same, if distributed * * *."

the Income Tax Act of 1913, c. 16, 38 Stat. 114, 166: the partnership itself is not taxed,[10] but it prepares and files a return in much the same manner that is required of an individual taxpayer,[11] and the partners are required to take into their income their distributive shares of partnership income.[12] In *Heiner* v. *Mellon*, 304 U.S. 271, this Court held that "distributive share" meant "proportionate share", rather than "distributable share", and that partners are required to take into their individual income their distributive, or proportionate, shares of partnership income even though applicable state law prevented distribution. In so holding, it referred with approval (304 U.S. at 281, n. 8) to O.D. 187, 1 Cum. Bull. 174 (1919), in which the Treasury had held that partnership income was currently taxable to the partners in the amount of their distributive shares although by contract it could not be distributed until later years. Consistently with *Heiner* v. *Mellon*, and with O.D. 187, the courts have uniformly held that part-

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[10] Sec. 701.

[11] Secs. 703, 6031.

[12] Secs. 61(a)(13), 702(a), 704. The phrase "distributive share" originated in Sec. 218(a) of the Revenue Act of 1918, c. 18, 40 Stat. 1057.

The correlative of these provisions is that amounts distributed are not taxed to a partner upon distribution unless the amount of money distributed is in excess of the partner's basis in his partnership interest. Sec. 731(a)(1). That basis is increased by the partner's distributive share of partnership income, and decreased by distributions to him, and by his distributive share of partnership losses. Secs. 705(a), 733.

ners must currently take into their individual incomes their proportionate shares of partnership income even though by reason of consensual arrangements, disputes, ignorance, concealment, the force of law, or otherwise, the partnership income was not available for distribution.[18]

It follows that if, as we have shown earlier, Health Plan's payments to the trust constituted partnership income, then the respondent partners were required to take into their income their increased distributive shares of the partnership income, despite any contractual arrangement, by trust or otherwise, to hold distribution in abeyance. Contrary to the court of appeals' understanding (Pet. 37, 41), the government's position that the payments to the trust constituted partnership gross income, and consequently gross income to the partners, does not turn on an "entity" or "conduit" theory of partnerships. Those concepts can come into play only where there is a question of characterizing income for special treat-

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[18] *Starr* v. *Commissioner*, 267 F. 2d 148 (C.A. 7); *United States* v. *Baker*, 233 F. 2d 195 (C.A. 10); *Hulbert* v. *Commissioner*, 227 F. 2d 899 (C.A. 7); *Bell* v. *Commissioner*, 219 F. 2d 442 (C.A. 5); *Commissioner* v. *Goldberger's Estate*, 213 F. 2d 78 (C.A. 3); *First Mechanics Bank* v. *Commissioner*, 91 F. 2d 275 (C.A. 3); *Bourne* v. *Commissioner*, 62 F. 2d 648 (C.A. 4), certiorari denied, 290 U.S. 650; *Beck Chemical Equipment Corp.* v. *Commissioner*, 27 T.C. 840; *deCousser* v. *Commissioner*, 16 T.C. 65; *Halkias* v. *Commissioner*, 12 T.C. 1091; *Freudmann* v. *Commissioner*, 10 T.C. 775.

ment (*e.g.*, capital gains).[14] Here there is no question that compensation for services is ordinary income to a partnership, and to a partner. See Sections 61(a)(1) and 702(a)(9). With respect to the payments here involved, the treatment is the same whatever theories of partnership may be embodied in the Internal Revenue Code.

The errors of the courts below, in addition to their disregard of *Lucas* v. *Earl*, appear to have arisen because they persisted in viewing the respondents only as contingent beneficiaries of the trust, rather than as partners in a partnership that had earned income. But the fact that the partners were also contingent beneficiaries of the trust is quite irrelevant. The government has not sought to tax the physician-employees, who were equally contingent beneficiaries. It has not sought, and does not seek, to support its assessments against the partners because they were contingent beneficiaries. The Internal Revenue Code would command the result for which we contend in this case with respect to the partnership and the partners whether only some of the partners were contingent beneficiaries of the trust, or whether the potential beneficiaries included no partners at all, but were children, relatives, or other objects of the partnership's largesse. It can hardly diminish the partners' liability for tax on their shares

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[14] See Wolfman, *Level for Determining Character of Partnership Income—"Entity" v. "Conduit" Principle in Partnership Taxation*, 19 N.Y.U. Institute on Federal Taxation 287 (1961).

of partnership income that they were the principal contingent beneficiaries of the trust.

The court of appeals persisted in this error when it concluded (Pet. 36) that had respondents "contracted individually with * * * [Health Plan] for payments into a retirement trust subject to the same conditions involved here, they would not be subject to taxation in the years the payments were made." Under *Lucas* v. *Earl*, an individual physician (or, for that matter, a corporation) contracting with Health Plan, with similar provisions for payments to a trust for himself and his employees, or for relatives or others, would be taxed currently on amounts irrevocably paid to the trust because, as to him, such payments would be no more than deflected compensation for services rendered. Cf. *Hogle* v. *Commissioner*, 132 F. 2d 66 (C.A. 10); *Jones* v. *Page*, 102 F. 2d 144 (C.A. 5). The cases upon which the court below relied (Pet. 36) would be relevant, irrespective of whether an individual, a corporation, or a partnership contracted with Health Plan, only if the government looked to the trust as a source of income to beneficiaries, such as employees, who might never receive payment. They are of no relevance where, as here, the contracting party (the partnership) was irrevocably compensated by the bargained-for payments to the trust, and where we are concerned only with the tax liabilities of the individual partners, whether they were or were not beneficiaries of the trust.

III.

THE DECISION BELOW EFFECTIVELY CIRCUMVENTS THE LIMITATIONS UPON QUALIFIED PENSION TRUSTS ESTABLISHED BY THE INTERNAL REVENUE CODE OF 1954.

Section 401 of the Internal Revenue Code of 1954, Appendix, *infra*, as effective during the years in controversy, provides for qualified pension trusts and establishes the terms upon which the Congress has sanctioned deferred compensation plans, with the tax benefits of current deductibility to the employer and deferred taxation of the employee. Among other conditions, such a trust must be "for the exclusive benefit of * * * employees or their beneficiaries." Section 401(a). Moreover, such a trust must not discriminate in favor of officers, supervisory employees, or highly compensated employees. Section 401(a)(4). Because of these conditions, there could be no qualified pension trust for the benefit of self-employed individuals, whether partners or sole proprietors, during 1960 and 1961. Though that restriction has been relaxed somewhat in later years by amendments to the Code effected by the Self-Employed Individuals Tax Retirement Act of 1962, P.L. 87-792, 76 Stat. 809, the conditions imposed even under the relaxed provisions remain rigorous, both as to discrimination in favor of highly compensated individuals, and as to amounts that may be contributed to a pension trust for the benefit of partners rather than employees.

The trust here involved, which was principally for the benefit of partners, and otherwise provided bene-

fits only for professional physician-employees,[15] could not qualify under either the standards of 1960 and 1961 or those of later years. Yet, contrary to the explicit statutory limitations on qualified pension trusts, the decision below produces for the partnership and the partners the principal tax benefits of such a trust, and thus openly invites partnerships to circumvent the requirements carefully devised by Congress as conditions to obtaining these benefits.[16] Under the decision, there is nothing to prevent partnerships, large and small, and in any business or profession, from establishing similar plans to avoid tax on whatever portion of their compensation they choose to defer.

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[15] The record herein does not establish the number of persons other than physician-employees employed by Medical Group. But the Medical Service Agreement (Ex. B, R. 114-157) by its references to Other Personnel, to union-negotiated increases in wages and salaries, and to non-discrimination in employment, makes it abundantly clear that Medical Group had a substantial number of employees other than its physician-employees. (R. 116, 121-122, 129-130, 138, 155, 156.)

[16] If the trust had constituted a pension trust for employees qualified under Section 401, the payments to the trust by Health Plan would still have constituted gross income to the Medical Group partnership but would, at the same time, have given rise to an offsetting deduction by Medical Group. However, since, on several grounds, including the fact that it was principally for the benefit of partners, the trust was not a qualified pension trust under Section 401, the offsetting deduction would be denied by Section 404, Appendix, *infra*. By ignoring *Lucas* v. *Earl* and permitting the partnership simply to be by-passed by payments to the trust, the decision below effectively circumvents the limitations of Section 404.

CONCLUSION

For the reasons stated, the judgments of the court of appeals should be reversed.

Respectfully submitted.

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APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 61. GROSS INCOME DEFINED.

(a) *General Definition.*—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;

* * * *

(13) Distributive share of partnership gross income;

* * * *

SEC. 401. QUALIFIED PENSION, PROFIT-SHARING, AND STOCK BONUS PLANS.

(a) *Requirements for Qualification.*—A trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries shall constitute a qualified trust under this section—

(1) if contributions are made to the trust by such employer, or employees, or both, or by another employer who is entitled to deduct his contributions under section 404(a)(3)(B) (relating to deduction for contributions to profit-sharing and stock bonus plans), for the purpose of distributing to such employees or their beneficiaries

the corpus and income of the fund accumulated by the trust in accordance with such plan;

(2) if under the trust instrument it is impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, purposes other than for the exclusive benefit of his employees or their beneficiaries;

* * * *

and

(4) if the contributions or benefits provided under the plan do not discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees.

* * * *

SEC. 404. DEDUCTION FOR CONTRIBUTIONS OF AN EMPLOYER TO AN EMPLOYEES' TRUST OR ANNUITY PLAN AND COMPENSATION UNDER A DEFERRED-PAYMENT PLAN.

(a) [as amended by Sec. 24, Technical Amendments Act of 1958, P.L. 85-866, 72 Stat. 1606] *General Rule.*—If contributions are paid by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan, or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such contributions or com-

pensation shall not be deductible under section 162 (relating to trade or business expenses) or section 212 (relating to expenses for the production of income); but, if they satisfy the conditions of either of such sections, they shall be deductible under this section, subject, however, to the following limitations as to the amounts deductible in any year:

* * * *

(5) *Other plans.*—In the taxable year when paid, if the plan is not one included in paragraph (1), (2), or (3), if the employees' rights to or derived from such employer's contribution or such compensation are nonforfeitable at the time the contribution or compensation is paid.

* * * *

SEC. 701. PARTNERS, NOT PARTNERSHIPS, SUBJECT TO TAX.

A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.

SEC. 702. INCOME AND CREDITS OF PARTNER.

(a) *General Rule.*—In determining his income tax, each partner shall take into account separately his distributive share of the partnership's—

* * * *

(9) taxable income or loss, exclusive of items requiring separate computation under other paragraphs of this subsection.

* * * *

SEC. 703. PARTNERSHIP COMPUTATIONS.

(a) *Income and Deductions.*—The taxable income of a partnership shall be computed in the same manner as in the case of an individual except that—

(1) the items described in section 702(a) shall be separately stated, and

* * * *

SEC. 704. PARTNER'S DISTRIBUTIVE SHARE.

(a) *Effect of Partnership Agreement.*—A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this section, be determined by the partnership agreement.

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